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CLASS LIFE OF FLOATING GAMING FACILITIES
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ISSUE

Under the circumstances set out below, what are the appropriate asset classes and recovery periods of floating gaming facilities?

FACTS

Taxpayers in the gaming industry include individuals, partnerships, corporations, and joint ventures operating gaming casinos on various facilities located in or near United States inland river waterways, river basins, channels, lakes, ponds, and cofferdams. These operations are conducted under licenses issued by local and state gaming agencies. Often, state law prohibits gaming on land-based facilities and requires that the gaming facilities be on water. Operating casinos on the water are commonly referred to as "Riverboat Casinos." Operating casinos in water adjacent to land are commonly referred to as "Dockside Casinos."

Riverboat or Dockside Casinos currently operate in states that have legalized riverboat gaming, including: Mississippi, Louisiana, Missouri, Iowa, Illinois, and Indiana. Taxpayers operating Riverboat or Dockside Casinos conduct legalized gaming activities that include Blackjack, Poker, Roulette, Craps, Baccarat, Keno and Slot Machines. The gaming facilities are designed to attract gaming customers. In addition to the revenue from gaming, the gaming facilities derive revenue from food and beverage sales and entertainment. Most revenue is derived from gaming.

Two contrasting gaming facility fact patterns are set out below. Although these fact patterns involve a casino riverboat and a casino-facility-in-a-moat, the analysis is equally applicable to "permanently-moored" facilities and facilities located behind cofferdams.

FACT PATTERN 1 - CASINO RIVERBOAT

A casino operator either purchases or contracts with a U.S. shipyard to construct a U.S. flagged, self-propelled, marine vessel to be operated on the inland river waterways of the United States, on which gaming activities will be conducted. The motorized vessel is registered and documented with either a state government agency or the U.S. Coast Guard. The vessel has been issued a Certificate of Inspection (COI) by the U.S. Coast

Guard and carries passengers who engage in on-board gaming. The vessel is operated with a licensed crew and travels on United States waterways. The vessel has its own electric, water, sewage, and telecommunications systems, as well as a complete radar navigation system.

FACT PATTERN 2 - GAMING-FACILITY-IN-A-MOAT

A casino operator either purchases or contracts with a U.S. shipyard to construct a barge or several barge units. The barges are towed to an interim river location. An inland channel or canal from the river to a water basin is dredged. The barges are towed into the water basin or they are built in place and various marine and land based contractors weld the barges together so that they will be a single welded structure. The number of barges used depends on the size of the structure permitted to operate under local and state government zoning requirements. The canal or channel is then backfilled so that the welded structure is completely isolated from a waterway.

The gaming facility is constructed by incorporating the welded structure as part of its foundation. After a layer of concrete is poured onto the common surface of the welded barges to create a level surface, a multi-story facility is constructed. The structure is held in place by hoists with cables that are anchored to the land with concrete caps on piles. Walls and a roof are then constructed around or attached over the welded structure. The gaming facility floats in a basin of water the depth of which is usually maintained by a pumping system. This enables the gaming facility to comply with local and state law gaming agency requirements. The gaming facility does not have its own independent electric, water, sewage, or telecommunications systems. Additionally, it does not have a complete radar navigation system. Land-based utilities provide electric, water, sewage, and telecommunications services.

Construction of the gaming facility must be under the direction of a licensed contractor and requires approved zoning and building plans. The local city or county building authority grants the gaming facility a certificate of occupancy upon completion. Local government fire marshals monitor the gaming facility for maximum occupancy levels.

LAW

Section 167(a) of the Internal Revenue Code provides a depreciation allowance for property used in a trade or business or held for the production of income. Property is eligible for the allowance when it is ready and available for a specifically assigned function. See sections 1.46-3(d) and 1.167(a)-10(b) of the Income Tax Regulations.

The depreciation deduction provided by section 167(a) of the Code for tangible property placed in service after 1986 generally is determined under section 168. This section prescribes two methods of accounting for determining depreciation allowances. One method is the general depreciation system in section 168(a) and the other method is the alternative depreciation system in section 168(g). Under either depreciation system, the

depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

The applicable recovery period for purposes of either section 168(a) or 168(g) is determined by reference to class life. Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former section 167(m) as if it were in effect and the taxpayer were an elector under that section. Prior to its revocation, section 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary that reasonably reflects the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) of the regulations sets out the method for asset classification under former section 167(m) of the Code. Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities.

Rev. Proc. 87-56, 1987-2 C.B. 674, sets forth the class lives of property that are necessary to compute the depreciation allowances under section 168. Property that is neither described in an asset guideline class listed in section 5 of the revenue procedure nor assigned a class life under section 168(g)(3)(B) of the Code is treated as property having no class life. For purposes of the general depreciation system, section 168(e)(3)(C) prescribes a 7-year recovery period for property with no class life, and for purposes of the alternative depreciation system, section 168(g)(2)(C) prescribes a 12-year recovery period for property with no class life.¹

The Standard Industrial Classification Manual (SIC) published by the Office of Management and Budget can provide insight into the content of the current asset classes described in Rev. Proc. 87-56. Care must be exercised because SIC does not make use of the same classification techniques and depreciation concepts of Rev. Proc. 87-56. While SIC has precise categorization by primary business activity using language very similar to that found in Rev. Proc. 87-56, the revenue procedure departs dramatically from the categorization scheme of SIC by establishing two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities.

Each asset described in asset classes 00.11 through 00.4, in addition to the requirement of trade or business use, must possess section 167 attributes sufficient to

¹ For purposes of this paper, it is assumed that the assets were placed in service before January 1, 1999. For property placed in service after December 31, 1998, the recovery period for regular income tax and for alternative minimum tax purposes is the same. Sections 168(a)(2)(C)(i) and 56(a)(1)(A)(i).

be eligible for the depreciation allowance as a specific asset. For example, a railroad car must be ready and available for commercial operation as a railroad car rather than some other form of use, such as a restaurant.

The asset classes set out in Rev. Proc. 87-56 that are germane to the classification of the gaming facilities in each of the fact patterns are as follows:

79.0 Recreation:

Includes assets used in the provision of entertainment services on payment of a fee or admission charge, as in the operation of bowling alleys, billiard and pool establishments, theaters, concert halls, and miniature golf courses. Does not include amusement and theme parks and assets, which consist primarily of specialized land improvements or structures, such as golf courses, sports stadium, racetracks, ski slopes, and buildings which house the assets used in entertainment services.

Assets used primarily in asset class 79.0 have a recovery period of 7 years for purposes of section 168(a) and 10 years for purposes of section 168(g). The SIC category numbers for establishments engaged in operating various gaming devices and casino operations are 7993 and 7999, respectively. Asset class 79.0 includes gaming activities. This paper assumes that the assets at issue are primarily used in gaming activities.

00.28 Vessels, Barges, Tugs, and Similar Water Transportation Equipment, except those used in marine construction.

There is no further description for this class. Assets described in asset class 00.28 have a recovery period of 10 years for purposes of section 168(a) and 18 years for purposes of section 168(g). Any vessel, barge, tug, and similar water transportation equipment used as such primarily in the activity described in asset class 79.0 is classified in asset class 00.28.

00.3 LAND IMPROVEMENTS:

Includes improvements directly to or added to land, whether such improvements are section 1245 property or section 1250 property, provided such improvements are depreciable. Examples of such assets might include sidewalks, roads, canals, waterways, drainage facilities, sewers (not including municipal sewers in Class 51), wharves and docks, bridges, fences, landscaping shrubbery, or radio and television transmitting towers. Does not include land improvements that are explicitly included in any other class, and buildings and structural components as defined in section 1.48-1(e) of the regulations. Excludes public utility initial clearing and grading land improvements as specified in Rev. Rul. 72-403, 1972-2 C.B. 102.

Assets described in asset class 00.3 have a recovery period of 15 years for purposes of section 168(a) and 20 years for purposes of section 168(g). Any land improvement used primarily in the activity described in asset class 79.0 is classified in asset class 00.3.

Nonresidential real property has a recovery period of 39 years for purposes of section 168(a) of the Code and 40 years for purposes of section 168(g). Sections 168(a) and 168(g)(2)(c). Section 168(e)(2)(B) defines "nonresidential real property" as section 1250 property which is not residential rental property or property with a class life of less than 27.5 years.

Section 168(i)(12) provides that "section 1250 property" has the same meaning as section 1250(c). This section provides that section 1250 property is any real property, other than section 1245 property, which is or has been of a character subject to the allowance for depreciation provided in section 167. Section 1245 property is any property of a character subject to the allowance for depreciation under section 167 and is either (a) personal property, (b) other tangible property (not including a building or its structural components) used in connection with a qualified activity or a research or storage facility used in connection with a qualified activity, (c) a single purpose agriculture or horticultural structure, (d) a storage facility used in connection with the distribution of petroleum. Section 1245(a)(3). Pursuant to section 1.1245-3(c)(2) of the regulations, the terms "buildings" and "structural components" shall have the meanings assigned to those terms in section 1.48-1(e).

A building is defined in section 1.48-1(e)(1) of the regulations as any structure or edifice enclosing space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display or sales space. The term includes, for example, apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by or for a lessee even if such structure must be removed or ownership of such structure reverts to the lessor at the termination of the lease.

Additional factors to consider in determining whether a structure is a building include inherent permanency, the appearance of the structure, and the function of the structure. See L.L. Bean, Inc. v. Commissioner, T.C. Memo 1997-175. Determining if a structure is inherently permanent requires a consideration of six factors set forth in Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664, 672-73 (1975). These factors are:

(1) Is the property capable of being moved, and has it in fact been moved? Alabama Displays, Inc. v. United States, 507 F.2d 849 (Ct. Claims 1975); Moore v. Commissioner, 58 T.C. 1045, 1052 (1972), aff'd. per curiam 489 F.2d 285 (5th Cir. 1973);

(2) Is the property designed or constructed to remain permanently in place? Weirick v. Commissioner, 62 T.C. 446, 451 (1974); Everhart v. Commissioner, 61 T.C. 328 (1973); Roberts v. Commissioner, 60 T.C. 861, 866 (1973);

(3) Are there circumstances, which tend to show the expected or intended length of affixation, i.e., are there circumstances, which show that the property may or will be moved? Alabama Displays, supra; LaCroix v. Commissioner, 61 T.C. 471 (1974);

(4) How substantial a job is removal of the property and how time consuming is it; is it readily removable? Estate of Shirley Morgan v. Commissioner, 52 T.C. 478 (1969);

(5) How much damage will the property sustain upon its removal? King Radio Corp. v. United States, 486 F.2d 1091, 1096 (10th Cir. 1973); and

(6) What is the manner of affixation of the property to the land? Weirick, supra; Everhart, supra; Roberts, supra.

In L.L. Bean the taxpayer contended that even if its facility resembled and functioned as a building it was not an improvement to land because it was movable. The court stated that proper application of the Whiteco factors rests on the premise that movability itself is not the key determinant of lack of permanence, and the mere fact that the taxpayer's facility could theoretically be moved did not establish that it was not inherently permanent. In finding that the taxpayer's facility was inherently permanent the court noted that the facility was specifically designed for the site as an addition to taxpayer's distribution center and that the time and effort involved to move the facility would be substantial. With regard to another asset at issue in L.L. Bean, the Mezzanine System (system), the court found that the taxpayer's building was planned and designed with the integration of the system in mind and concluded that the substantial time and effort involved in both the construction and potential removal of the system, as well as the degree of its integration with the building, reflected the permanent nature of the system.

Section 7701(m)(1)(7) of the Code refers to 1 U.S.C. section 3 for the definition of "vessels." That section provides:

The word "vessel" includes every description of watercraft or other artificial contrivance used, or capable of being used, as a means of transportation on water.

See also 46 U.S.C. section 2101(45).

A "barge" is a non-self-propelled vessel. 46 U.S.C. section 2101(2).

In a recent series of decisions, courts have held that for purposes of the application of federal statutes, other than federal income tax statutes, dockside casinos are not vessels and state law is not determinative of a vessel's status for federal purposes. Although these cases are not controlling, they are nevertheless informative.

In Biloxi Casino Belle Inc., 176 B.R. 427 (S.D. Miss 1995), the court held that the dockside casino was not a vessel even though the Coast Guard had previously documented it as such. The court noted that the Biloxi Belle had very few of the attributes commonly associated with a vessel. For example, it was not capable of moving under its own power, was not seaworthy, had no crew concerned with vessel operations other than the activities relating to the casino, and had no standard maritime equipment such as navigational lights or lifesaving equipment. See also In the Matter of Treasure Bay, 205 B.R. 490 (S.D. Miss 1997); McAdow v. Promus Companies, Inc., 926 F.Supp. 93 (W.D. La 1996); King v. President Riverboat Casino-Mississippi, Inc., (S.D. Miss 1995) (the structure was, for all intents and purposes a land-based casino).

In Pavone v. Mississippi Riverboat Amusement Corp., 52 F.3d 560 (5th Cir. 1995), the Court of Appeals affirmed the District Courts for the Eastern District of Louisiana and the Southern District of Mississippi, holding that a floating dockside casino facility was not a vessel for purposes of the Jones Act, 46 App. U.S.C. section 688, or general maritime law. In its holding the court found three attributes common to non-vessels. The structure was built to be used primarily as a work platform; the structure was moored at the time of the accident; and although the platform was capable of movement, and was sometimes moved across navigable waters in the course of normal operations, any transportation was merely incidental to its primary purpose.

In King v. Grand Casinos of Mississippi, Inc., 697 So.2d 439 (Sup. Ct. Miss. 1997), plaintiff argued that the dockside casino was a vessel because it was licensed as such under Mississippi state law. The Court stated that the state statute did not determine the issue of vessel status under the federal Jones Act.

U.S. Coast Guard Rules

The U.S. Coast Guard Marine Safety Manual, Volume II paragraph 10. I. 1 (see also, 46 CFR 71.01-1 and 46 CFR 91.01-1), has a classification for "Vessels In Immobile Status" that includes "Permanently Moored Vessels". An abstract of the Safety Manual states, in pertinent part, the following:

I. Vessels in Immobile Status.

1. Permanently Moored Vessels.

(a) Introduction. A floating fuel dock, showboat, theater, hotel, restaurant, museum, etc., is not a "vessel" for inspection purposes if it is permanently moored and thus taken out of navigation. In this manner, the entity is "substantially a land structure" and not subject to the inspection laws. However, it may be subject to other regulations, such as those promulgated under the Ports and Waterways Safety Act

(PWSA). The following criteria should be used in determining whether an entity is "substantially a land structure."

- (1) It must be securely and substantially moored as approved by the U.S. Coast Guard Office in Charge of Marine Safety (OCHI).
- (2) The mooring must be so rigged that its lines cannot be inadvertently or accidentally cast off, it is unlikely to break away from its mooring, and it cannot be moved away from the mooring without special effort (i.e., the use of tools).
- (3) Permanent connection to shore side facilities is evidence of being a "land structure". The nature and use of the entity may also be considered.

- (b) Change in Use. A vessel may be placed in navigation periodically, yet keep its status as "substantially a land structure" when moored. When returned to navigation, it becomes subject to inspection under the regulations applicable to its particular operation. The owner or operator must notify the U.S. Coast Guard, Office of Marine Inspection, prior to placing the vessel in navigation. When the vessel is again immobilized, the U.S. Coast Guard, Office of Marine Inspection, must approve the mooring arrangement before the vessel can be considered "permanently moored." Once these conditions are met, the vessel would again be considered out of navigation. This procedure is intended to allow the "permanent" mooring of a vessel that is placed in navigation on a regular basis (e.g., weekly or monthly trips between ports). When intended operations are tantamount to use as a vessel normally requiring inspection, claims of status as substantially a land structure are voided and the structure must be inspected and certified. [Note: Local authorities should be advised whenever a vessel's status is changed to "substantially a land structure", so that appropriate civil safety codes may be applied.]

ANALYSIS/CONCLUSION

FACT PATTERN 1 - CASINO RIVERBOAT

The casino riverboat is used by the casino operator in the business activity described in asset class 79.0, Recreation, of Rev. Proc. 87-56 because it is used primarily in the gaming business. However, the casino riverboat is described in asset class 00.28, Vessels, Barges, Tugs and Similar Water Transportation Equipment, because during the taxable year it was certified by the U.S. Coast Guard and was otherwise ready and available, within the meaning of section 168 of the Code, to operate as a vessel in the casino operator's business. Consequently, the casino riverboat has a recovery period of 10 years for purposes of section 168(a) and 18 years for purposes of section 168(g). However, should the casino riverboat lose its certification or otherwise fail to be ready and available as an asset described in asset class 00.28 for any taxable year, the asset would be subject to the change-in-use rules of section 168(i)(5).

FACT PATTERN 2 - GAMING-FACILITY-IN-A-MOAT

The barges are used as an inextricable part of a multi-story, landlocked, gaming facility used primarily in the business activity described in asset class 79.0, Recreation, of Rev. Proc. 87-56. Unlike the casino riverboat, the barges are permanently moored within the meaning of the Marine Safety Manual and are no longer ready and available for operation as water transportation equipment. Thus, the gaming facility is not an asset described in asset class 00.28, Vessels, Barges, Tugs and Similar Water Transportation equipment of Rev. Proc. 87-56. See Appendix A for a list of further criteria helpful in determining whether an asset is "otherwise ready and available" in order to be described in asset class 00.28.

The fact that the gaming facility is permanently moored within the meaning of the applicable U.S. Coast Guard rules is not, by itself, determinative that the facility is an inherently permanent structure for depreciation purposes. Whether the gaming facility is inherently permanent is determined by application of the Whiteco factors. A gaming facility that is determined to be an inherently permanent structure that meets the definition of a building found in section 1.48-1(e) of the regulations and satisfies the criteria of appearance and function cited by the court in L.L. Bean would be classified as nonresidential real property under section 168 of the Code. Asset class 79.0, Recreation, does not include buildings.

Application of the Whiteco factors indicates that the gaming facility is an inherently permanent structure. The manner of its attachment to the land, which incorporates concrete and steel pilings, and the sheer size of the multiple-floor structure indicate that there is no intent to move the gaming facility. Further, in view of the length of the backfilled canal, any movement of the facility to another site (assuming permits could be obtained) would be prohibitively time consuming and expensive. Compare and contrast Fox Photo and L.L. Bean. Consequently, the gaming-facility-in-a-moat is an inherently permanent structure.

Furthermore, the gaming facility encloses space within its walls, is covered by a roof, and provides workspace. Accordingly, it meets the definition of a building provided by section 1.48-1(e) of the regulations. In addition, this gaming facility, which looks like and functions as a building, satisfies the criteria discussed by the court in L.L. Bean. The gaming facility functions as a casino, always located at the exact same place. The facility provides a wide range of gaming activities and food. In function, it is not different from any casino located along the Las Vegas strip. Therefore, the gaming facility is nonresidential real property for purposes of section 168 of the Code and has a recovery period of 39 years for purposes of section 168(a) and 40 years for purposes of section 168(g).

If, upon application of the Whiteco factors, a particular gaming facility is determined to be impermanent, the gaming facility would be an asset described in asset class 79.0, Recreation, rather than nonresidential real property.

Under sections 1.1250-1(e)(2), 1.1245-1(c), and 1.48-1(e)(2), a building includes its structural components. Thus, any property that is enclosed within or attached to a gaming facility that is nonresidential real property must be analyzed to determine if the property is a structural component of the gaming facility. In summary, in addition to those items specifically set out in section 1.48-1(e)(2), structural components include any permanently attached item that is not considered machinery and equipment. In Fact Pattern 2, any property item that is not a structural component is tangible personal property described in asset class 79.0, Recreation (unless it is a specific depreciable asset, described in asset classes 00.11 through 00.4, that is used in all business activities). See Hospital Corporation of America, 109 T.C. 21 (1997), acq., 1997-55 I.R.B. 314, Cf. Boddie- Noell Enterprises, Inc. v. United States, 36 Fed.Cl. 722 (1996) aff'd without op. 132 F.3d 54 (Fed. Cir. 1997); LaPetite Academy, Inc. v. United States, 95 U.S.T.C. (CCH) 50,193, (W.D. Mo. 1995), aff'd without op. 72 F.3d 133 (8th Cir. 1995).

Whether any of the gaming facility assets in Fact Pattern 2 are described in asset class 00.3, Land Improvements, must be considered. The type of assets described in asset class 00.3 consists of section 1250 property and other inherently permanent section 1245 property. Thus, any casino facility that is not nonresidential real property because of its impermanence would likewise fail to be described in asset class 00.3. However, any property permanently attached to land that is the same as, or comparable to, the examples set out in asset class 00.3, such as wharves and docks, is described in asset class 00.3 and has a 15-year recovery period for purposes of section 168(a) and a 20-year recovery period for purposes of section 168(g). (Such assets may also be used in conjunction with the casino boat discussed in Fact Pattern 1).

Precisely the same law and analysis discussed in Fact Patterns 1 and 2 apply to other factual variations of floating gaming facilities. For example, rather than a gaming facility constructed in a moat apart from a waterway, a gaming facility can be constructed in or moved to a site on or adjacent to a river and confined in a cofferdam. Alternatively, a gaming facility may be substantially moored to a wharf or pier. In each instance, the analysis would entail considerations of whether the gaming facility had been permanently moored and removed from navigation under the applicable U.S. Coast Guard rules and whether the gaming facility is inherently permanent within the meaning of the Whiteco factors. With regard to the intended length of affixation factor, cognizance should be taken of the relative costs of the water-based and land-based facilities. (Where the cost of land-based facilities greatly exceeds the cost of water-based facilities it is unlikely that the water-based facilities would be moved, even if such movement were theoretically possible). In addition, in some instances it may be appropriate to make use of the integrated structure analysis discussed by the court in L.L. Bean in the permanency determination. An intense factual analysis on a case-by-case basis is required for each variation of floating gaming facility.

CHANGE IN METHOD OF ACCOUNTING

A change to correct a taxpayer's consistently used improper method, recovery period, or convention for computing the taxpayer's depreciation deduction is a change to the taxpayer's method of accounting, subject to the provisions of sections 446 and 481 of the Code.

Appendix A

Some factors for determining whether a floating gaming facility is ready and available for use as an asset described in asset class 00.28.

Registered with U.S. Coast Guard or similar governmental authority.

Certified by the Coast Guard as a seaworthy vessel.

Periodically surveyed by a shipping classification society, such as the American Bureau of Shipping (ABS) with the classification "active".

Designed by a marine architect.

Built in a shipyard and not by a general contractor.

A "Plimsoll" or loadline welded onto the hull where the water line is located.

Carries life Preservers.

Qualifies for section 7518 Marine Capital Construction Fund (CCF) Administered by Maritime Administration (MARAD).

Qualified for a Title XI guarantee mortgage by MARAD.

Self-propelled and maintains its own independent utilities, such as electric, water and sewage system.

Propelled by motorized vessels (Pushed or Towed).

Has an independent navigation system.

Communication is generally ship to shore.

Employees are required to have specific active types of licenses and are certified for such positions as ship captain, 1st officer, radio officer, engineer officer 1st mate, etc.

Certain functions require U.S. Coast Guard Stamps (i.e.-taking on fuel on a vessel require persons in charge, Red Baker flag must be flown while bunkering the vessel).

Document charter parties are covered under marine admiralty law.

Insurance of shipboard employees is under Jones Act Trade.

Carries hull and marine insurance issued by an Inland Marine Underwriters Association.

On mortgaged vessels there are certain assurances regarding the mortgage such as the "Preferred Ship Mortgage Act of 1920."

Flies a flag of the nation in which the vessel is registered.